

# Factors Influencing Voluntary Compliance by Sole Proprietors: Preliminary Survey Results

*Tom Beers, Eric LoPresti, and Eric San Juan,  
IRS Taxpayer Advocate Service, Internal Revenue Service*

A principal goal of the IRS is to maximize the extent to which taxpayers pay their taxes voluntarily and timely. To do so, the IRS needs to understand why they comply (or don't comply). The National Taxpayer Advocate 2007 Annual Report to Congress, which included a review of existing research (the "2007 Review") and the National Taxpayer Advocate 2010 Annual Report to Congress, which included a proposal for this research (the "2010 Proposal") identified numerous types of noncompliance, as shown below.<sup>1</sup>

**TABLE 1. Typology of Noncompliance<sup>2</sup>**

Type	Description
Procedural	Failed to follow complicated procedural rules, such as quarterly filing requirements
Lazy	Failed to follow burdensome procedural rules, such as recordkeeping requirements
Unknowing	Misunderstood the legal rules
Asocial	Motivated by economic gain
Brokered	Acted on the advice of a professional
Symbolic	Perceived the law or the IRS as unfair
Social	Acted in accordance with social norms and peer behavior
Habitual	Knowingly repeated previous noncompliance

The 2007 Review and 2010 Proposal also identified various factors driving taxpayer compliance decisions. The Taxpayer Advocate Service (TAS) conducted a study to investigate whether and how these factors affect voluntary compliance by sole proprietors (*i.e.*, those who file Form 1040, Schedule C, *Profit or Loss from Business*), as described in the 2010 Proposal. The factors are reflected in the following table:

<sup>1</sup> See National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) [hereinafter "2007 Review"]; National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 71-88 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*) [hereinafter "2010 Proposal"]. Because the 2007 Review and the 2010 Proposal cite much of the literature discussing each of the relevant factors, this paper does not revisit that underlying literature or theoretical basis for the factors previously identified.

<sup>2</sup> See 2010 Proposal at 81 (Table 2.4.1, *Typology of Noncompliance and Potentially Operative Factor(s) Identified by the Literature*) (citing Robert Kidder and Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 Taxpayer Compliance 57, 56-62 (1989) and Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 5 Kans. L. Rev. 1, 23-33 (2003)).

**TABLE 2. Factors Identified as Potentially Driving Compliance Behavior<sup>3</sup>**

Factor	Description
Deterrence	"People comply when the potential sanction multiplied by the perceived likelihood of getting caught outweighs the economic gain from cheating." [However,] "the deterrence model is incomplete because it seems economically irrational for so many taxpayers to comply given the low probability of getting caught cheating."
Norms	"According to social norms and reciprocity theories, taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying."
Tax morale	Taxpayers "who cheat may feel guilty when they break the norm if it has been adopted as the taxpayer's own tax morale." In addition, "those who trust the government and feel the tax laws and procedures are fair and fairly enforced may be more likely to feel a moral obligation to comply, even if the outcome of those procedures is unfavorable."
Trust	Taxpayers "may use unfair rules or procedures, unreasonable penalties, bad experiences with the IRS, or a lack of faith in government or the IRS to justify either reducing efforts to comply or active noncompliance."
Complexity and convenience	"Taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance."
Preparers and other third parties	"Tax preparers may have a significant effect on tax compliance."

TAS also asked questions about demographics and affiliations. While these items may not directly affect compliance decisions, TAS included them because they may be correlated with or help explain the factors that do. For example, information about a person's affiliations could help TAS draw conclusions about the person's norms, tax morale, and related factors.<sup>4</sup>

TAS focused on sole proprietors because underreporting by sole proprietors represents the largest portion of the tax gap (*i.e.*, taxes not voluntarily and timely paid).<sup>5</sup> The IRS is unlikely to be able to detect or deter non-compliance by this segment through enforcement alone without expending significant resources because most sole proprietor income is not subject to third-party information reporting. Relatively inexpensive measures, such as document matching and correspondence examinations, cannot reliably detect such income. Thus, it is particularly important for the IRS to gain a better understanding of how to improve compliance among sole proprietors using levers other than economic deterrence.

TAS contracted with a consulting firm, Russell Research, to help conduct a telephone-based survey of two groups: a nationally representative sample of sole proprietors (the "National Survey"); and sole proprietors located in high- and low-compliance communities (the "Community Survey"). The discussion below describes the methodology and key preliminary results of both surveys.

## Discussion

### Methodology

**TAS sorted taxpayers with DIF scores in the highest or lowest deciles into low- or high-compliance groups.**

TAS relied on internal IRS statistical estimates of the likelihood that an audit would produce a significant adjustment (called a Discriminant Function or "DIF" score) as a proxy for a person's tax compliance, as described in the 2010 Proposal.<sup>6</sup> The IRS develops DIF scores for individual taxpayers in each "examination activity

<sup>3</sup> The factors and their descriptions come from the 2010 Proposal (pages 76–81), which synthesized them from tax compliance literature, including the 2007 Review.

<sup>4</sup> 2010 Proposal at 87.

<sup>5</sup> IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), available at <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>.

<sup>6</sup> The DIF is a computer algorithm that estimates the likelihood that an audit of a particular return would produce an adjustment. The DIF is based on data obtained and periodically updated from IRS National Research Program examinations. See 2010 Proposal at 86 n. 49 (and sources cited therein).

code” or EAC. For sole proprietors, EACs are defined by the taxpayer’s total gross receipts (TGR) on Schedules C and F and total positive income (TPI), which is positive income from all sources before adjusting for deductions, exemptions, or negative income (*e.g.*, negative income from post-holiday returns). TAS excluded the EACs for low-income taxpayers claiming the earned income tax credit (EITC) because they may present a unique set of tax compliance issues.<sup>7</sup> For Tax Year 2009, six EACs included all sole proprietors residing in the United States who did not claim the EITC, as shown in the following table.

**TABLE 3. Total Gross Receipts (TGR) and Total Positive Income (TPI) Limits for Certain Schedule C Examination Activity Codes (EACs)<sup>8</sup>**

EAC	TGR	TPI
274	<\$25,000	<\$200,000
275	\$25,000 - \$99,999	<\$200,000
276	\$100,000 - \$199,999	<\$200,000
277	>\$199,999	<\$200,000
280	-	\$200,000 - \$999,999
281	-	>\$999,999

For each of the six EACs,<sup>9</sup> TAS sorted all Tax Year 2009 returns by DIF score, then divided each group into ten deciles. Taxpayers with returns in the first and second deciles have the lowest DIF scores and are assumed to be the most compliant. Those in the ninth and tenth deciles have the highest DIF scores and are assumed to be the least compliant.<sup>10</sup> All other deciles are considered moderately compliant.

To minimize selection bias and the number of surveys required, TAS selected a random sample of taxpayers in high- and low-compliance groups in each EAC for the National Survey. However, TAS combined the four EACs with the fewest taxpayers into two groups (or “strata”) with two EACs in each of these two strata. TAS also selected one group of taxpayers with medium levels of compliance from all EACs for comparison purposes. TAS received 3,306 responses to the National Survey, as shown on the following table.

**TABLE 4. National Survey Responses by Strata and Population**

National Sample Strata	Population	Responses
EAC 274 DIF Deciles 1 – 2	2,053,331	350
EAC 274 DIF Deciles 9 – 10	2,053,331	350
EAC 275 DIF Deciles 1 – 2	571,075	351
EAC 275 DIF Deciles 9 – 10	571,075	384
EACs 276, 277 DIF Deciles 1 – 2	268,565	359
EACs 276, 277 DIF Deciles 9 – 10	268,565	350
EACs 280, 281 DIF Deciles 1 – 2	256,306	383
EACs 280, 281 DIF Deciles 9 – 10	256,306	379
All EACs DIF Deciles 3 – 8	9,447,830	400
Total	15,745,384	3,306

<sup>7</sup> Because it is sometimes difficult to distinguish between a hobby and a real business, TAS considered, but ultimately rejected, the idea of excluding those in the lowest income ranges. Thus, the survey may have captured the views of some taxpayers who were conducting a hobby. However, the number of respondents likely to fall into that category was limited because TAS stratified the sample by EAC, as described below.

<sup>8</sup> IRS, Document 6209, *IRS Processing Codes and Information* 12–16 (Jan. 2012). Many parts of Document 6209 are designated as “official use only,” but these EAC definitions are not.

<sup>9</sup> Each EAC was treated separately because the formulas that produce the DIF scores are unique to one EAC. So, for example, a specific DIF score in one EAC doesn’t have the same meaning in a different EAC.

<sup>10</sup> As noted below, this assumption is a significant limitation of the study. TAS relied on DIF scores because taxpayers—particularly noncompliant taxpayers—might not respond accurately to questions about the extent of their own tax compliance. Although DIF scores are not perfect predictors of noncompliance, those in the top two deciles are likely to be less compliant than those in the bottom two deciles. Nonetheless, using this approach to classify people or geographic areas as “high-compliance” or “low-compliance” (as we do in this paper) must be viewed as very approximate—not definitive.

The national sample was large enough that we can be at least 95 percent confident that the results reflect the views of the universe of taxpayers in each stratum with a margin of error of 5 percent or less.

**TAS identified communities with median DIF scores in the highest and lowest deciles as low- or high-compliance communities, but found few high-compliance communities.**

TAS originally intended the Community Survey sample to have 2 strata with 350 respondents each, from high-compliance communities and low-compliance communities, cities, towns, and other geographic areas across the country identified by addresses with ZIP codes reported by the taxpayers on their returns. To be considered “high compliance,” a community’s residents must have a median DIF score in the bottom 30 percent (*i.e.*, the bottom three deciles). To be considered “low compliance” a community’s residents must have a median DIF score in the top 30 percent (*i.e.*, the top three deciles). However, the location of taxpayers with high levels of compliance (or at least low DIF scores) was such that TAS could not identify enough high-compliance communities to generate 350 respondents. Simply put, there were few high-compliance communities. In particular, the criteria above yielded three U.S. geographic communities.<sup>11</sup> The distribution of high- and low-compliance taxpayers and communities was a significant discovery. In the end, the Community Survey had 535 respondents—362 from low-compliance communities and 173 from high-compliance communities.<sup>12</sup>

**TAS developed survey questions and contracted with Russell Research to administer the survey.**

TAS developed telephone-based survey questions to investigate the factors suggested by the tax compliance literature, as described above. TAS used the same questions for both the National and Community Surveys.

TAS contracted with Russell Research to refine the survey questions, administer the surveys, and compile summary statistics.<sup>13</sup> Russell Research conducted all interviews by telephone from January 3, 2012, to April 19, 2012. It contacted potential respondents up to four times. The response rate was 56 percent for the national sample and 54 percent for the community sample. This better-than-average response rate should help to minimize the likelihood that the survey results were affected by selection bias—the possibility that the views of nonrespondents are significantly different from the views of respondents.<sup>14</sup>

### ***Important Assumptions and Limitations***

**TAS used DIF scores as a proxy for compliance by those in the top and bottom DIF deciles.**

As discussed in the 2010 Proposal, it is difficult to measure actual compliance with perfect accuracy. Taxpayers are not likely to confess any noncompliance in response to a survey, and even detailed audits conducted by the IRS’s National Research Program (NRP) are likely to contain errors. Even assuming that NRP audit results, as adjusted by IRS researchers, reflect actual compliance, the audit itself has an effect on the taxpayer’s attitude about the tax system, potentially biasing the taxpayer’s response to any subsequent survey. Thus, TAS decided not to survey taxpayers who had been subject to an NRP audit. While surveying taxpayers immediately before they were subject to an NRP audit might have been more productive, TAS deemed it overly deceptive. Thus, TAS opted to rely on DIF scores as an imperfect, but acceptable, measure of actual compliance, at least for those in the top and bottom DIF deciles.<sup>15</sup>

<sup>11</sup> In addition, the high-compliance criteria identified a military and a Native American community. This identification allows for future study, potentially observing mechanisms of authority and cohesion in those communities. For this phase of the study, however, the Army Post Office did not identify a geographic community as did other addresses, and the Native American community, with a quasi-sovereign history, had a fiduciary relation to the federal government (which was the subject of some survey questions).

<sup>12</sup> The DIF score for a particular survey respondent, however, may not correspond to the DIF score of the community. For example, the response of a taxpayer with a DIF score suggesting a high level of noncompliance could have been selected as a representative of a high-compliance community. The Community Survey was geographically limited. The goal was to look at the compliance norm in the geographic community and how institutions in that area might be influencing that norm; the sample was to be representative of the locality rather than another pool.

<sup>13</sup> The actual survey questions, along with a topline analysis by Russell Research, are reproduced in Appendices I and II, respectively, of National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1–70 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*), available at <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report> (last visited Aug. 8, 2013).

<sup>14</sup> See, e.g., Scott Keeter, et al., *Gauging the Impact of Growing Nonresponse on Estimates from a National RDD Telephone Survey*, 70 Pub. Op. Quart. 759–79 (2006). It may also suggest that taxpayers were somewhat more interested in discussing their views about taxes than other subjects.

<sup>15</sup> Although some taxpayers in our sample had been subject to IRS examination or collection activity, we did not exclude them or place them into the noncompliant group, as the activity could have had an effect on their subsequent compliance behavior. Of course, any direct contact with the IRS could affect their views about the IRS and the survey results.

As noted above, this study assumes that taxpayers with high DIF scores (*i.e.*, in the ninth or tenth decile) are noncompliant and that those with low DIF scores (*i.e.*, in the first and second decile) are compliant. To the extent this assumption is incorrect, the survey results could be misleading. However, by excluding those in the middle deciles from the high- and low-compliance groups, TAS sought to improve the likelihood that taxpayers in those groups did, in fact, have high or low levels of reporting compliance.<sup>16</sup>

### **The Community and National Surveys are different in kind.**

While the National Survey is statistically representative of the United States, the Community Survey of select communities relates to a different kind of data. The National Survey may reflect a response of the general population, but given the necessarily varied circumstances across the country, may not relate that response to any particular set of local conditions that could provide a deeper context. On the other hand, the Community Survey facilitates analysis of responses in relation to a more specific set of social circumstances. Thus, the Community and National Surveys are complementary.

TAS did not design the Community Survey sample for projection to any larger group of taxpayers. As set forth above, noncompliance (and by extension, compliance) may vary according to a typology. Focusing on a community permits identification of types, if any, that may not be nationally prevalent. The purpose of the Community Survey would not be to project an ideal type on other parts of the country, but rather to identify relevant factors or characteristics, such as trust in government or traditions of authority, that may occur outside the community context as well.<sup>17</sup> Similarly, in American studies, Middletown stands as a landmark (eponymously popularized by Public Broadcasting System (PBS) television) not because research on Muncie, Indiana (for which it was a pseudonym) was representative of the U.S. but because of the depth in which investigation of one community contextualized national trends.<sup>18</sup> In short, the Community Survey may be prototypical rather than typical.

TAS randomly selected taxpayers for the Community Survey from high- and low-compliance communities without excluding taxpayers with unrepresentative DIF scores. Accordingly, the high-compliance community sample includes taxpayers who are noncompliant and who would be included in the low-compliance group for purposes of the National Survey. Conversely, the low-compliance community sample includes taxpayers who are compliant and who would be included in the high-compliance group for purposes of the National Survey. Thus, responses from high-compliance communities may not be similar to responses from the high-compliance group, and responses from the low-compliance communities may not be similar to responses from the low-compliance group.

### **Key Findings of the National Survey<sup>19</sup>**

The National Survey results are statistically representative of the views of Schedule C filers in the high- and low-compliance groups. As discussed in the 2007 Review and 2010 Proposal, a large body of research discusses the potential effect of various factors on tax compliance, but this study is the first to link survey responses to IRS estimates of the respondent's actual tax compliance. Thus, the National Survey results provide an unprecedented look at the differences between the views of the Schedule C filers that are the most and least compliant, at least according to IRS estimates.

<sup>16</sup> Per TAS research on 2006 NRP data, assessments for taxpayers in the top 20 percent of DIF scores were significantly higher on average than those for the lowest 20 percent.

<sup>17</sup> For example, one military community appeared to be highly compliant, but that is not the only U.S. military population, where others may be embedded in different contexts.

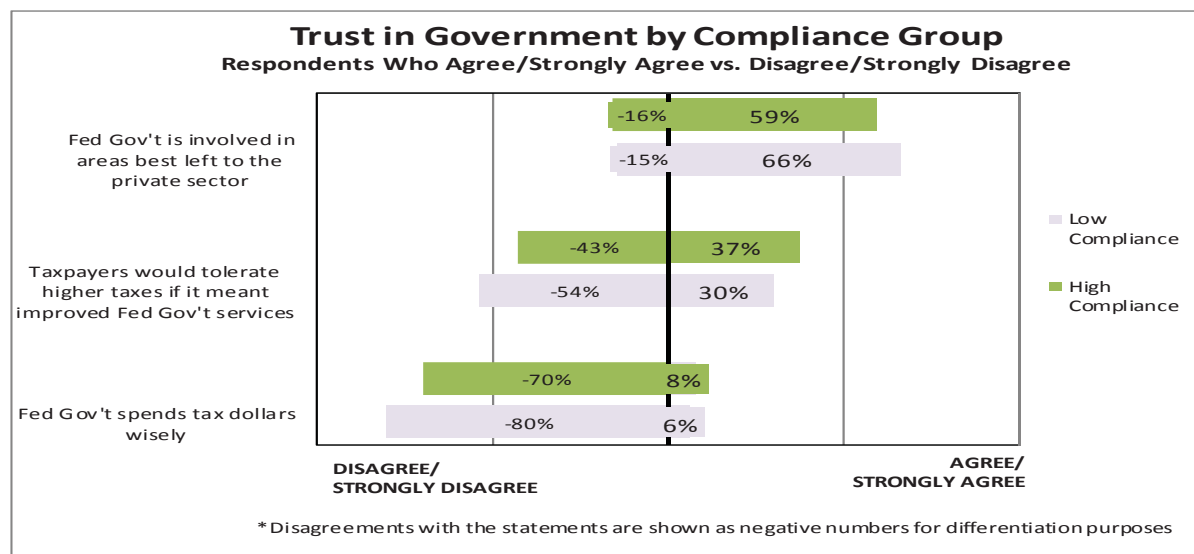
<sup>18</sup> Middletown (Muncie, Indiana) has been the subject of voluminous research on American social institutions. See *The First Measured Century* (PBS 2000); *Middletown* (PBS 1982); Theodore Caplow, et al., *All Faithful People: Change and Continuity in Middletown's Religion* (Minneapolis: Univ. of Minn. Press, 1983); *Middletown Families: Fifty Years of Change and Continuity* (Minneapolis: Univ. of Minn. Press, 1982); Rob't & Helen Lynd, *Middletown in Transition: A Study in Cultural Conflicts* (NY: Harcourt Brace, 1937); *Middletown: A Study in Modern American Culture* (NY: Harcourt Brace, 1929).

<sup>19</sup> This discussion of the National Survey cites aggregate figures that are weighted by EAC and DIF decile to reduce selection bias when projecting the summary statistics to the population of sole proprietors. For example, if five percent of the survey responses came from members of a stratum that made up 10 percent of the sole proprietor population, TAS gave the responses from that stratum more weight when computing summary statistics. Except as otherwise indicated, the discussion in this section generally focuses on findings where there are statistically significant differences (at a 95-percent level of confidence) between the high- and low-compliance groups.

### Taxpayers in the high-compliance group were more likely to trust the government and the IRS.

Taxpayers in the high-compliance group were more likely to trust the government than those in the low-compliance group, potentially suggesting that negative views about the government promote symbolic noncompliance, as described in the typology (above). For example, those in the high-compliance group were less likely to agree that the government is involved in areas best left to the private sector (59 percent of the high-compliance group agreed vs. 66 percent of the low-compliance group), more likely to support higher taxes in exchange for improved government services (37 percent vs. 30 percent), and more likely to believe that the federal government spends tax dollars wisely (80 percent of the low-compliance group disagreed vs. 70 percent of the high-compliance group).<sup>20</sup> These results are generally consistent with research suggesting that trust in government has a positive effect on compliance.<sup>21</sup>

**FIGURE 1. Trust in the Federal Government by Compliance Group**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

### Most taxpayers believe tax laws are unfair.

Only 15 percent of both groups agreed or strongly agreed that the tax laws are fair. Rather, most taxpayers believe that:

- Large businesses have loopholes to reduce their taxes that smaller businesses do not have;
- The wealthy have ways of minimizing their taxes that are not available to the average taxpayer;
- Not everyone pays his or her fair share; and
- The federal tax laws are unfair.

However, the low-compliance group was somewhat more likely to view the tax law as unfair than the high-compliance group (65 percent vs. 61 percent for the high-compliance group), which would be consistent with

<sup>20</sup> Most taxpayers in both groups (70 percent) also agreed or strongly agreed that taxes fund important government benefits and services.

<sup>21</sup> See, e.g., Swedish Tax Agency, *Right From The Start, Research and Strategies* 6–7, 38–51 (Aug. 2005) (after surveying many papers from various disciplines, concluding that trust for tax agencies is an important determinant of voluntary compliance); Kristina Murphy, *The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders*, 28 Law and Human Behavior 187 (Apr. 2004) (finding that perceptions of procedural fairness and trust in the taxing authority had an impact on the motivation to comply); Tom R. Tyler, *Why People Obey the Law* 58–62 (Princeton Univ. Press 2006) (finding that “legitimacy” (defined as the perceived obligation to follow the law even if it is morally wrong, and respect and support for legal institutions, such as police and courts) has a significant positive impact on compliance after controlling for other variables). See also Joint Committee on Taxation, JCS-6-98, *General Explanation of Tax Legislation Enacted in 1998*, 19 (Nov. 24, 1998) (describing the 1998 IRS reorganization as needed to restore public confidence in the IRS, in large part, because “the Congress believed that most Americans are willing to pay their fair share of taxes, and that public confidence in the IRS is key to maintaining that willingness.”); *Taxpayer Compliance, Volume 1: An Agenda for Research* 118 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (summarizing various studies that suggest commitment, attitudes toward the IRS, law, and government may have an impact on tax compliance).

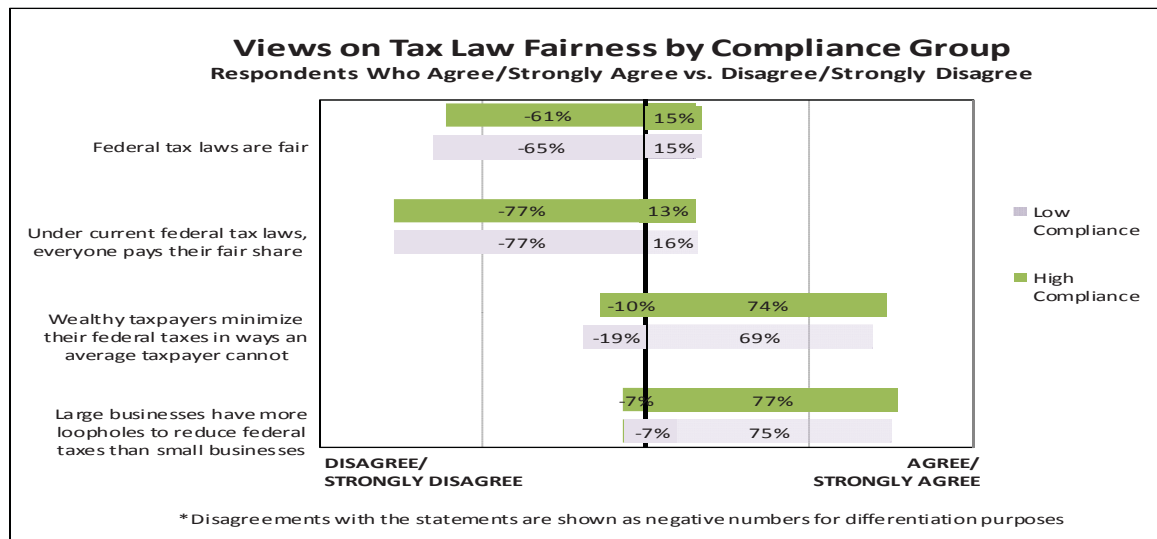


symbolic noncompliance.<sup>22</sup> These views may lend support to calls for tax simplification as a way to increase tax compliance.

*Those in the low-compliance group expressed less faith in the IRS.*

The low-compliance group generally held more negative views about the IRS, potentially suggesting that negative views of the IRS promote symbolic noncompliance.<sup>23</sup> For example, those in the high-compliance group were more likely to believe that the IRS treats taxpayers fairly (47 percent of the high-compliance group agreed vs. 42 percent of the low-compliance group). The low-compliance group, by contrast, was more likely to report that the IRS is disrespectful (20 percent vs. 15 percent), and more concerned with collecting as much as it can than with collecting the correct amount of tax (42 percent vs. 25 percent—a 17-point difference!). Without adequate safeguards, the IRS's increasing use of automated procedures could give taxpayers this impression, which in turn, may contribute to noncompliance. These results may suggest the IRS could increase compliance by treating taxpayers fairly and publicly committing to initiatives promoting procedural justice and respect for taxpayers, thus promoting positive views about itself.<sup>24</sup>

**FIGURE 2. Views About Tax Law Fairness by Compliance Group**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

On the other hand, the low-compliance group was somewhat more likely to agree “that the IRS will work with you if you have difficulty paying your taxes,” as 55 percent agreed vs. 49 percent for the high-compliance group. However, this view might have a greater effect on payment compliance than on reporting compliance. It could also reflect differences in knowledge about IRS procedures held by the groups. As noted below, the low-compliance group generally had more contact with the IRS.

<sup>22</sup> This difference is not statistically significant at a 95-percent level of confidence.

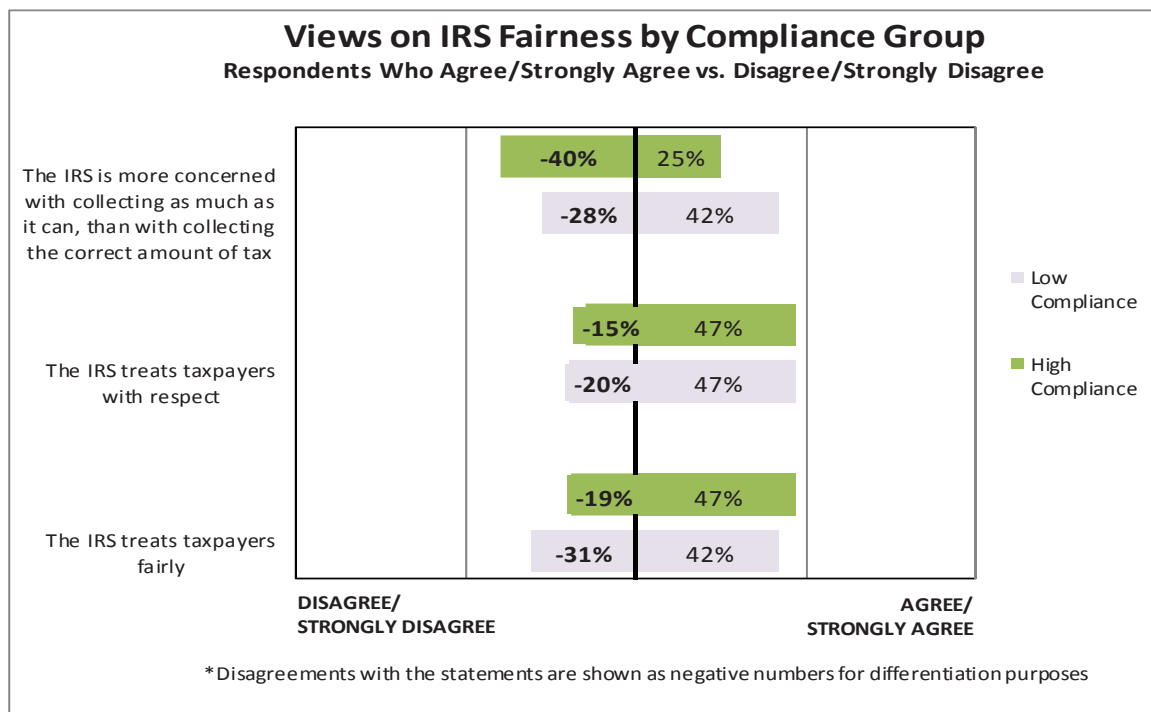
<sup>23</sup> This inference is consistent with previous research. See, e.g., *Taxpayer Compliance, Volume 1: An Agenda for Research* 93–96 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (discussing various studies).

<sup>24</sup> When IRS computers automatically propose adjustments and issue liens without reviewing all of the available information, the IRS appears more interested in collecting as much as possible than in collecting the correct amount. The National Taxpayer Advocate has suggested a wide range of steps the IRS could take to give taxpayers more confidence in the results of correspondence examinations, math error adjustments, and assessments against nonfilers. See, e.g., National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 63 (correspondence examination recommendations); National Taxpayer Advocate 2011 Annual Report to Congress 74 (math error recommendations); National Taxpayer Advocate 2011 Annual Report to Congress 93 (nonfiler recommendations). She has also recommended the IRS discontinue the practice of automatically filing the notice of federal tax lien (NFTL). See, e.g., National Taxpayer Advocate 2011 Annual Report to Congress 109, 128 (NFTL recommendations). Moreover, recent research suggests that collection alternatives (i.e., offers and installment agreements) are more closely associated with payment compliance than the automatic filing of a notice of federal tax lien. See *Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior*, *infra*.

*Those in the low-compliance group expressed less satisfaction with IRS services.*

Those in the low-compliance group were more likely than those in the high-compliance group to report that the IRS does not offer the tax services they need (25 percent vs. 18 percent), that it is difficult to access the services the IRS provides (25 percent vs. 17 percent), and that they were more dissatisfied with the quality of the IRS services (27 percent vs. 21 percent). Thus, a lack of satisfaction with IRS services may contribute to noncompliance (e.g., symbolic, procedural, lazy, or even unknowing noncompliance in terms of the typology), and the provision of better taxpayer services might increase tax revenue by improving compliance.

**FIGURE 3. Views About IRS Fairness by Compliance Group**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

*Those in the low-compliance group expressed less trust in a preparer.*

Those in the low-compliance group were more likely to report using a preparer than those in the high-compliance group (76 percent vs. 66 percent). This could be because the low-compliance group contained larger businesses (as noted below), facing larger tax preparation burdens. At least 90 percent of both groups reported that they always follow their preparer's advice, underscoring the importance of brokered compliance and non-compliance.<sup>25</sup> While both groups (79 percent and 80 percent of the low- and high-compliance groups, respectively) indicated they make sure they understand their return before signing, those in the high-compliance group were more likely to follow their preparer's advice than those in the low-compliance group (96 percent vs. 90 percent). This may suggest that preparers more often facilitate compliance instead of noncompliance.<sup>26</sup>

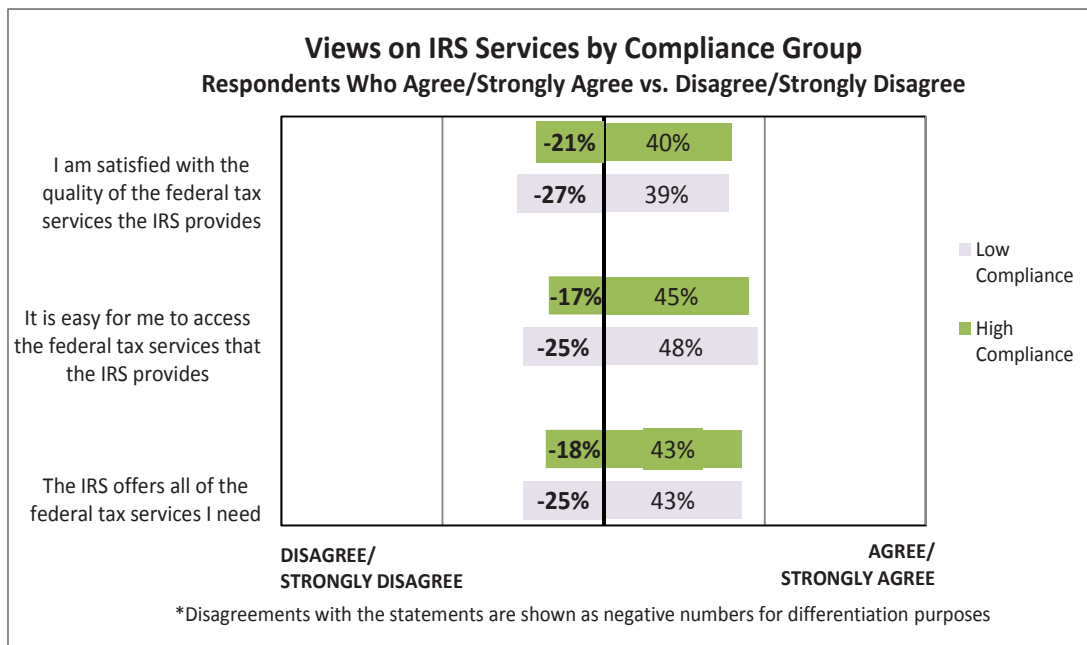
<sup>25</sup> As noted in the 2010 Proposal, the impact of the preparer on compliance probably depends on a combination of both the taxpayer's and the preparer's views toward compliance. Assume there are three types of preparers and taxpayers: (1) those who want to comply; (2) those who are willing to be more aggressive; and (3) those who are willing to cheat. Type one preparers may increase compliance by type two and type three taxpayers. Alternatively, those taxpayers may seek out type two or type three preparers. However, type two and type three preparers may reduce compliance by type one taxpayers unless those taxpayers either seek out type one preparers or are particularly resistant to the preparer's suggestions for tax savings. Similarly, type three taxpayers may pressure type one or type two preparers to be more aggressive than usual. See National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, § 3, 73 at 79-81 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility, and Competence*) (setting forth "The Types of Taxpayers and Preparers").

<sup>26</sup> Some research suggests preparers may improve compliance. See Steven Klepper, Mark Mazur, and Daniel Nagin, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J. L. and Econ. 205 (1991). See also Kim M. Bloomquist, Michael F. Albert, and Ronald L. Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, Proceedings of the 2007 IRS Research Conference 77 (2007) (finding preparers reduce math errors, but increase the incidence of potential misreporting). Other research suggests they do not reliably enhance compliance. See General Accounting Office (GAO), Continued on next page.



Those in the high-compliance group were also more likely than those in the low-compliance group to indicate that the person who prepares their return finds creative ways to minimize their taxes (35 percent vs. 28 percent). Perhaps the groups had different views about what it means to find creative ways to minimize taxes, with the low-compliance group expecting the preparer to propose more aggressive positions. Another possibility is that those from the low-compliance group may view their preparers as part of the tax system, which they do not trust, as the IRS increasingly enlists preparers in its efforts to improve tax compliance (e.g., by imposing due diligence requirements under Circular 230). Alternatively, those in the high-compliance group may simply seek out better preparers or at least have more meaningful conversations with them.

**FIGURE 4. Views About IRS Services by Compliance Group**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

**Taxpayers in the low-compliance group were more likely to participate in local organizations and to report that other participants view the law and the IRS negatively.**

Taxpayers in the high-compliance group were less likely than those in the low-compliance group to belong to a local business organization (11 percent vs. 16 percent), a local trade, labor, or other occupational organization (15 percent vs. 18 percent), or religious congregation (61 percent vs. 71 percent). To the extent association with these groups transmits local compliance norms, those norms appear to have a negative effect on compliance, rather than a positive one.

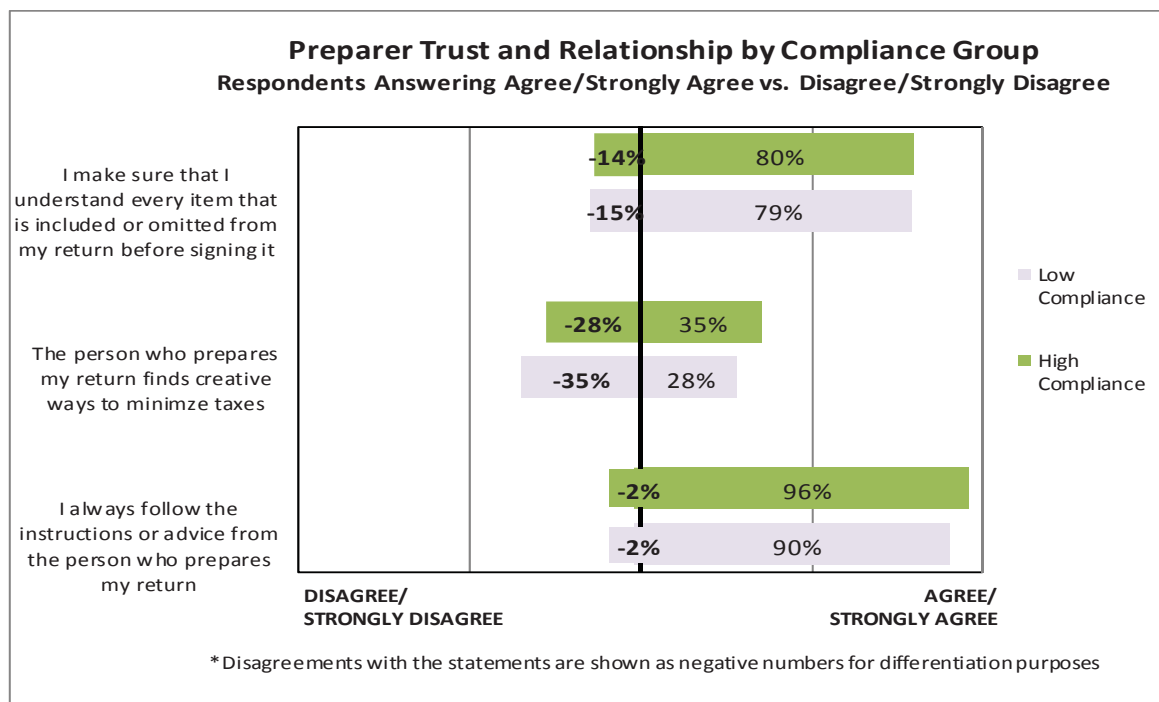
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GAO-02-509, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing* (2002) (finding in 1998 about two million taxpayers overpaid their taxes by failing to itemize even though about half used a preparer); Treasury Inspector General for Tax Administration (TIGTA), *Analysis of Statistical Information for Returns with Potentially Unclaimed Additional Child Tax Credit* (2003) (finding about 230,000 returns filed by paid preparers in 2002 where taxpayers appeared eligible for Additional Child Tax Credits they did not claim); Janet Holtzblatt and Janet McCubbin, *Issues Affecting Low-Income Filers*, in *The Crisis in Tax Administration* 148, 159 (Henry Aaron and Joel Slemrod eds., 2004) (observing that about two-thirds of EITC returns, which have high levels of noncompliance, were prepared by paid preparers); Government Accountability Office (GAO), GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 5, 23 (Apr. 4, 2006) (finding preparers made significant mistakes on 17 of the 19 returns prepared for GAO employees posing as taxpayers, including the omission of income on ten); TIGTA, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* 2 (Sept. 3, 2008) (finding preparers made mistakes on 17 of the 28 returns prepared for TIGTA employees posing as taxpayers, including six willful or reckless errors).

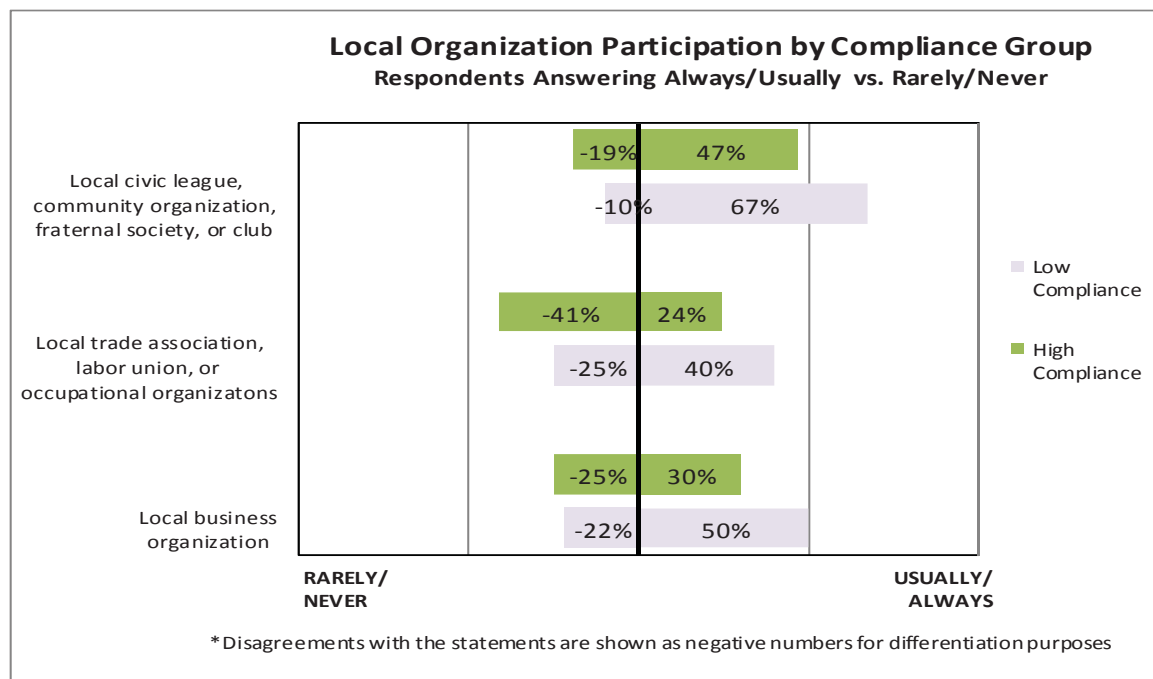
*Those in the low-compliance group were more likely to participate in local organizations.*

Among respondents who belong to local organizations, those in the low-compliance group were more likely to report that they usually participate. This was true for various organizations identified by the survey, including local business organizations (50 percent from the low-compliance group usually participate vs. 30 percent from the high-compliance group), local trade, labor, or occupational organizations (40 percent vs. 24 percent), and local civic, community, or fraternal organizations (67 percent vs. 47 percent). Thus, active participation in these groups appears to be negatively correlated with tax compliance, possibly promoting social noncompliance in terms of the typology. Perhaps those with a closer connection to local groups feel a weaker connection to the federal government, and a weaker obligation to comply with federal tax laws. They may also choose to associate with those who hold similarly negative views about the federal government and tax compliance, which reinforced their own views.

**FIGURE 5. Preparer Trust and Relationship by Compliance Group**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

**FIGURE 6. Local Organization Participation by Compliance Group**

Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

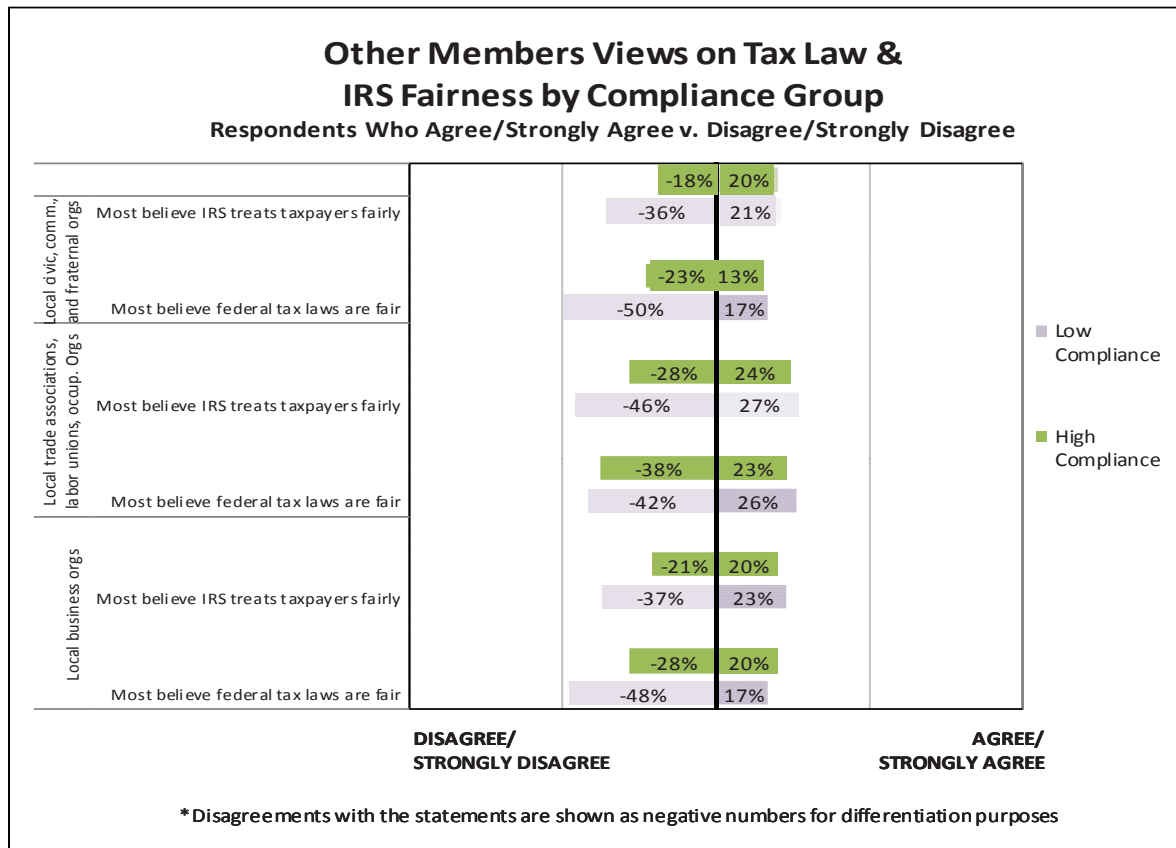
*Those in the low-compliance group were more likely to report that other members of local organizations view tax laws and the IRS negatively.*

Those in the low-compliance group were more likely than those in the high-compliance group to report that other members of local business organizations believe tax laws are unfair (48 percent of the low-compliance group vs. 28 percent of the high-compliance group) or that the IRS treats taxpayers unfairly (37 percent vs. 21 percent). They were somewhat more likely to report that other members of local trade, labor and occupational organizations believe tax laws are unfair (42 percent vs. 38 percent)<sup>27</sup> or that the IRS treats taxpayers unfairly (46 vs. 28 percent). They were also more likely to report that other members of local civic, community, and fraternal organizations believe the tax laws are unfair (50 percent vs. 23 percent) or that the IRS treats taxpayers unfairly (36 percent vs. 18 percent).<sup>28</sup> Participation in these organizations may have allowed taxpayers to learn that noncompliance is an acceptable norm among other participants, or perhaps they assumed that other participants shared their negative views. In any event, the differences in the responses to these questions by members of the high- and low-compliance groups may suggest that a person's perception about whether other participants in local organizations feel the tax law or the IRS is fair has an effect on their own compliance behavior (e.g., social and symbolic noncompliance), perhaps eroding tax morale.

<sup>27</sup> This difference is not statistically significant at a 95-percent level of confidence.

<sup>28</sup> Curiously, 53 percent of those in the moderate-compliance group also disagreed or strongly disagreed that other members of these organizations believe the IRS treats taxpayers fairly, and the difference between their response and the average response of members of both other groups was statistically significant at a 95-percent level of confidence. Perhaps those in the moderate-compliance group are more concerned about any perceived mistreatment of others by the IRS because they are still trying to comply, whereas more of those in the low-compliance group are slightly less concerned about fairness because they have either given up on the IRS or are noncompliant for other reasons.

**FIGURE 7. Other Members' Views About the Fairness of the Tax Law and the IRS by Compliance Group<sup>29</sup>**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence..

*While most respondents reported that small businesses comply, those in the high-compliance group were more likely to report that their competitors do not.*

According to social norms and reciprocity theories, taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying.<sup>30</sup> However, the survey did not find that those in the high-compliance group were more likely to report that competitors were complying. Rather, those in the high-compliance group were less likely to do so—agreeing that most of their competitors report all of their income only 22 percent of the time as compared to 31 percent for the low-compliance group.<sup>31</sup> Moreover, there was no significant difference in the views of each group about whether many small businesses report all of their income (26 percent of the high-compliance group agree and 15 percent disagree, but 27 percent of the low-compliance group agree and 16 percent disagree).<sup>32</sup>

Most members of both groups also reported that they would be embarrassed if others found out they did not report all of their income. It is possible that the low-compliance group answered these questions defensively or feigned innocence—to avoid giving the impression that they were cheating or that the government

<sup>29</sup> Taxpayers were asked to provide a response with respect to members of the local organization(s) with which they most closely associate.

<sup>30</sup> See, e.g., Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 Mich. L. Rev. 71 (Oct. 2003).

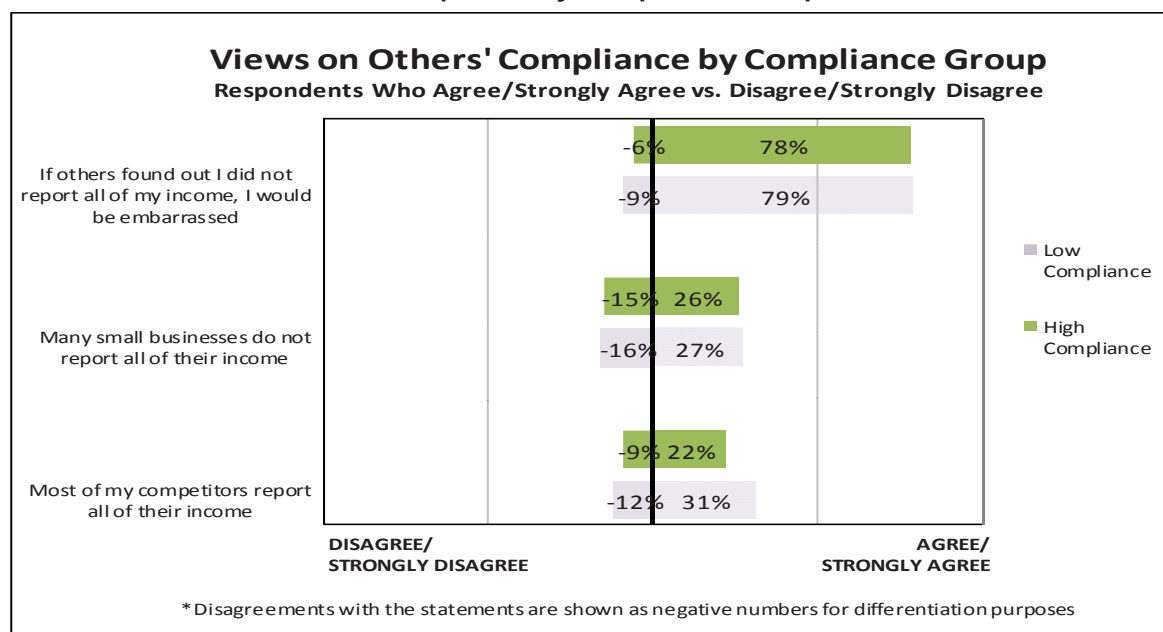
<sup>31</sup> However, most respondents (60 percent overall) were noncommittal, indicating they “don’t know” or “neither agree or disagree.”

<sup>32</sup> Both groups also reported that small businesses could survive even if they reported all of their income (54 percent of the high-compliance group vs. 56 percent of the low-compliance group). These differences are not statistically significant at a 95-percent level of confidence.

should do more to address noncompliance. Nonetheless, these results do not directly support the notion that social norms and reciprocity (at least among “most competitors”) drive compliance decisions. As noted above, the views of other members of local organizations toward the IRS seemed to have a greater correlation with compliance than whether most competitors comply. Perhaps the norms of that peer group are more important than the norms of competitors, though both groups said they would be embarrassed if others learned they were noncompliant.

In other words, the tax compliance decision may be less about the views of others or economics, and more about how the business views itself in relation to the federal government. As noted above, those with negative views toward the federal government more often associate with like-minded individuals at the local level.

**FIGURE 8. Views on Others' Compliance by Compliance Group**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

*Smaller businesses with local customers and those in professional or technical businesses were more often in the high-compliance group.*

The low-compliance group had larger businesses. The low-compliance group had an average of about seven employees, as compared to about four for the high-compliance group. Similarly, the low-compliance group had average gross receipts of about \$87,000, as compared to about \$46,000 for the high-compliance group.<sup>33</sup> The low-compliance group also identified its customers as “primarily national” more frequently—19 percent of the time—as compared to 17 percent for the high-compliance group. While the difference is small, this finding is somewhat curious in light of the finding that those in the low-compliance group feel a closer connection to local organizations than national ones, though some local organizations may be local chapters of national ones. Of course, business owners may feel more of a connection to local organizations that they chose to associate with than to customers with whom they may not interact in this age of e-commerce.

Another explanation could be that as businesses grow, the economic benefit of noncompliance increases but the expected penalty does not—a finding consistent with economic deterrence theory. However, this explanation seems inconsistent with the notion that smaller businesses, which are more likely to have informal

<sup>33</sup> Concerned that some taxpayers might have lower DIF scores simply because they have less income that is not subject to information reporting, and thus less opportunity to cheat, TAS analyzed the sample further. TAS looked at all income sources (not just Schedule C income) and found that taxpayers in the high-compliance group from each EAC strata reported a significant amount of income that is not subject to information reporting. Thus, while income transparency likely affects reporting compliance, its effect on a person's DIF score, if any, does not always overshadow other factors.

accounting systems and deal in cash, are less likely to be compliant than larger ones that need to have formal financial accounting systems to prevent theft and to reflect any positive net income on those systems and their tax returns to obtain financing.<sup>34</sup> However, even businesses in the low-compliance group were relatively small, possibly small enough to retain informal accounting systems.

Taxpayers in construction-related and real estate-related industries appeared to be less compliant than those in other industries, as they each comprised 9 percent of the low-compliance group, but only 4 percent of the high-compliance group. By comparison, those in professional and technical service industries appeared to be more compliant, comprising 26 percent of the high-compliance group and 17 percent of the low-compliance group.<sup>35</sup> Perhaps information reporting, which generally promotes compliance, was more prevalent among professional and technical service industries than in construction and real estate. Industry-related norms, the type of noncompliance involved, or the type of taxpayers involved, as described below in our analysis of the Community Survey, could also have played a role.

### **Both high- and low-compliance groups professed a “moral” obligation to report income accurately.**

Nearly all—96 percent of both groups—feel a moral obligation to report all of their income correctly. Moreover, those in the low-compliance group were more likely to say that everyone should correctly report all of their income—97 percent of the low-compliance group agree vs. 94 percent of the high-compliance group.<sup>36</sup> However, the low-compliance group may have answered these questions aspirationally (*e.g.*, they may not be living up to their aspirations because tax morale does not drive their tax compliance behavior) or defensively, to avoid making an admission.

### **Economic deterrence may not drive compliance decisions by those in either the high- or low-compliance groups.**

Those in the low-compliance group were more likely than those in the high-compliance group to report that achieving financial success is important (88 percent vs. 85 percent) and that taking risks is necessary to achieve financial success (68 percent vs. 61 percent).<sup>37</sup> One might expect people who express financial concerns, as both groups did, to be motivated by economic deterrence.

However, the survey responses provide little support for the view that economic deterrence has an effect on reporting compliance. In terms of the typology, the survey did not reveal asocial noncompliance. On one hand, those in the low-compliance group were more likely to agree that hearing about people who were caught underreporting makes them more careful with their own taxes (66 percent vs. 61 percent for those in the high-compliance group), a response consistent with the notion that economic deterrence (or a lack thereof) has a stronger effect on their compliance decisions than on those of respondents in the high-compliance group.<sup>38</sup>

<sup>34</sup> As noted above, the accuracy of the DIF scoring algorithm could affect the results. For example, if the DIF overestimates the actual compliance of small cash businesses, which generate income that is difficult to detect, then the results would indicate that small businesses are more compliant than they actually are.

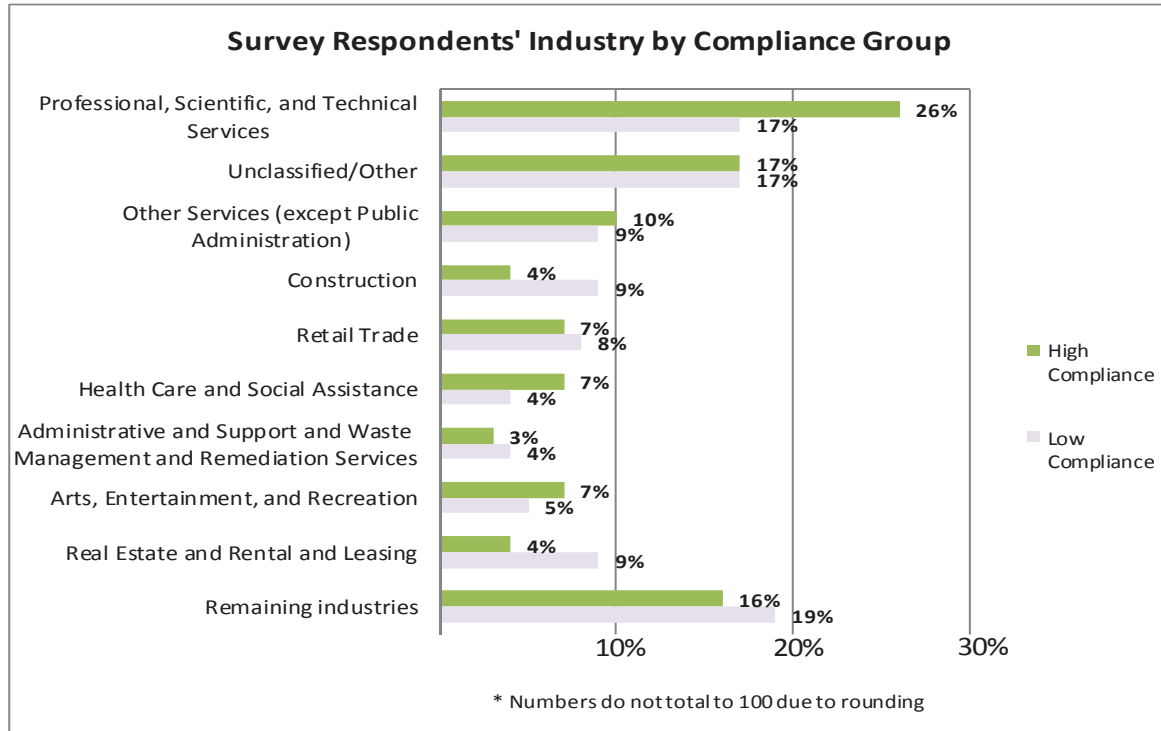
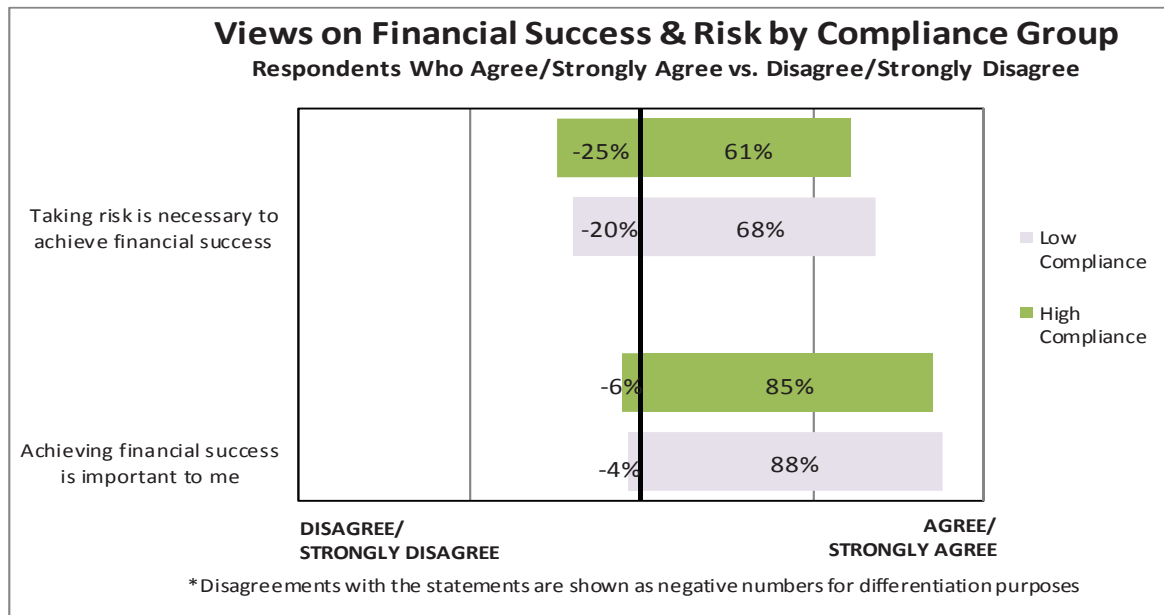
<sup>35</sup> Under “professional, scientific, and technical services,” the North American Industry Classification System (NAICS) includes legal, accounting, engineering, design, computer, management, research, and advertising services.

<sup>36</sup> This difference was not statistically significant at a 95-percent level of confidence.

<sup>37</sup> Those in the low-compliance group were also more likely to be male. Males are often thought to have less aversion to risk. See, *e.g.*, Alexandra Niessen and Stefan Ruenzi, *Sex Matters: Gender Differences in a Professional Setting*, Ctr. for Fin. Research, Working Paper No. 06-01, 14 (Feb. 2007), available at <http://hdl.handle.net/10419/57738>.

<sup>38</sup> This difference was not statistically significant at a 95-percent level of confidence. Of course, most people in both groups did acknowledge that such statements make them more careful, lending some support to economic deterrence theory.

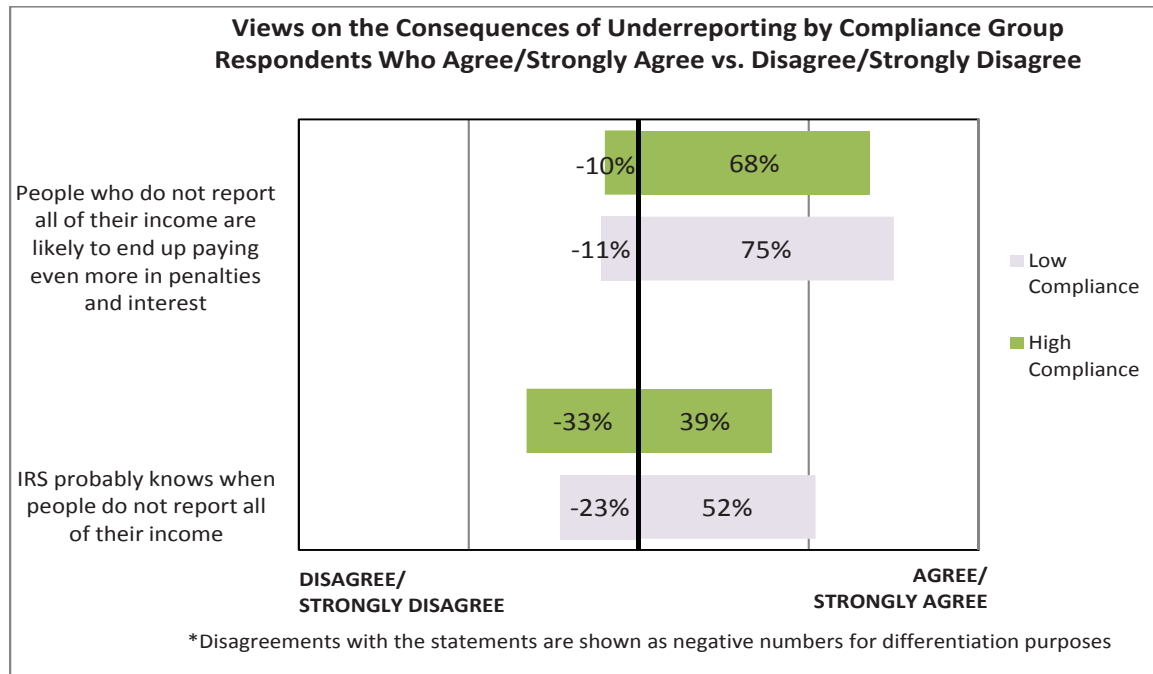


**FIGURE 9. National Survey Respondents' Industry by Compliance Group****FIGURE 10. Views on Financial Success & Risk by Compliance Group**

Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

On the other hand, those in the low-compliance group were also more likely to agree that the IRS probably knows when people do not report all of their income (52 percent vs. 39 percent for those in the high-compliance group); and that people who do not report all of their income are more likely to end up paying even more in penalties and interest (75 percent vs. 68 percent). If economic deterrence was a motivating factor for those in the low-compliance group, then (if answering truthfully) they might agree more often than those in the high-compliance group that it pays to cheat. They did not. Thus, the responses to these questions do not support the notion that a lack of economic deterrence drives noncompliance for those in the low-compliance group.<sup>39</sup>

**FIGURE 11. Views on the Consequences of Underreporting by Compliance Group**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

Alternatively, even though those in the low-compliance group generally do not believe it pays to cheat, they have slightly larger businesses, slightly more employees and may be willing to take more risk on their taxes if necessary to expand their businesses or to meet payroll, particularly if the alternative is to discontinue operations.<sup>40</sup> These are the same reasons that small businesses sometimes fail to make employment tax deposits.<sup>41</sup>

Another possibility is that responses by the small subset of the low-compliance group that had actually been caught cheating affected the results. Those in the low-compliance group had been subject to IRS examination or collection contacts more often than those in the high-compliance group. Nine percent of the low-

<sup>39</sup> Of course it is possible that those in the low-compliance group answered these questions defensively—to avoid the implication that they may not have reported all of their income.

<sup>40</sup> Indeed, the low-compliance group was more likely to agree that you have to take risks to succeed.

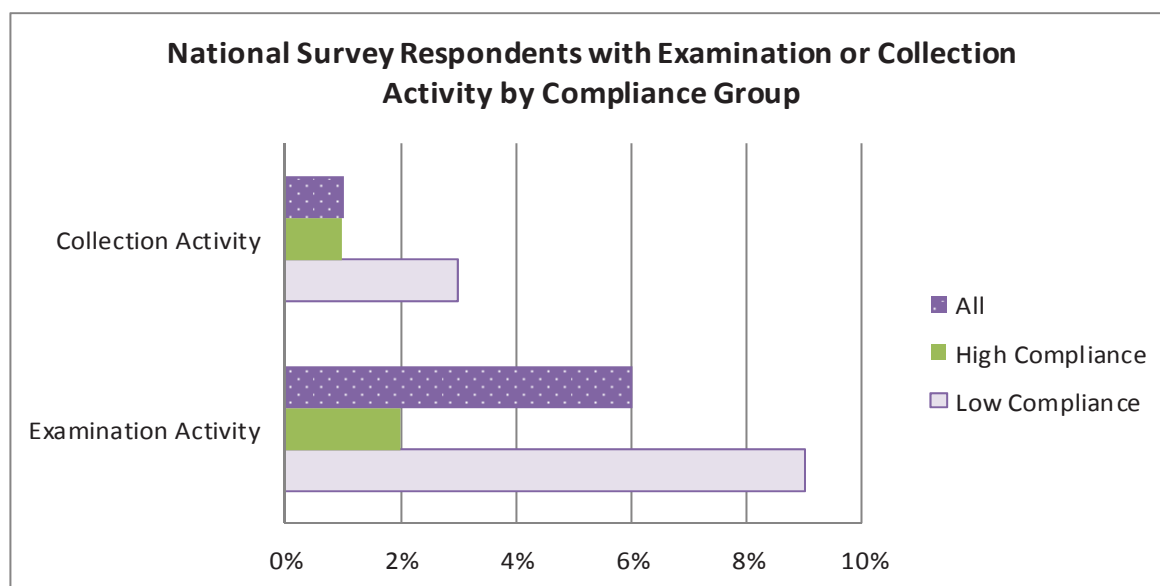
<sup>41</sup> See, e.g., SB/SE Research, 2009 Nationwide Tax Forum Focus Groups, DEN0116, *Your Clients and the Economy—How Can the IRS Help?* 3 (Jan. 2010) (“Because there is no money to pay expenses and meet obligations, participants stated that small business taxpayers are experiencing a number of secondary effects to include: falling behind on payments; not filing tax returns on time (or at all); going ‘underground’; and ‘burying their heads in the sand’.... [t]he IRS is not seen as a priority because small business taxpayers do not experience any immediate consequences of noncompliance. Therefore, payroll taxes and estimated taxes are last on the list.”). Consistently, IRS research finds that taxpayers who owe a balance upon filing their returns are more likely than others to understate their tax liabilities. See Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1–2 (July 14, 1995) (finding that “[o]n average, understated tax on balance due returns is ten times as large as understated tax on other returns.”).

compliance group had been subject to an IRS examination, as compared to 2 percent of the high-compliance group.<sup>42</sup> Similarly, 3 percent of the low-compliance group had been subject to IRS collection activity as compared to 1 percent of the high-compliance group.<sup>43</sup>

**Views about complexity were mixed, but most agreed the tax rules are so complicated it is very difficult to get a tax return exactly right.**

Researchers have suggested that taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance.<sup>44</sup> Survey responses about complexity were mixed and provide little insight about how complexity or burden affects compliance. On one hand, most taxpayers (more than 73 percent in both groups) agreed that their record-keeping system made it easy to compute their income tax. Most (about 64 percent overall) also agreed that the rules about what to report as income are clear. Thus, while complexity may have been a barrier to compliance for some, it was not a significant barrier for most respondents.

**FIGURE 12. Percentage of National Survey Respondents Subject to IRS Examination or Collection Activity by Compliance Group**



On the other hand, as noted above, most (70 percent of those who had tax preparation assistance) reported that they did not know the tax laws well enough to prepare their own returns. In addition, most agreed that the tax rules are so complicated that it is very difficult to get a tax return exactly right (56 percent overall agreed). However, taxpayers in the high-compliance group were more likely to agree with this statement than those in the low-compliance group (62 percent vs. 58 percent). Perhaps taxpayers in the high-compliance group were more concerned about making inadvertent errors than those in the low-compliance group.

### ***Summary of the National Survey Results***

Respondents from the low-compliance group were more likely to report that the government is too big and wastes tax dollars, that tax laws are unfair, and that the IRS is unfair (e.g., often believing the IRS is more

<sup>42</sup> IRS, Compliance Data Warehouse (2012).

<sup>43</sup> Id.

<sup>44</sup> See, e.g., *Taxpayer Compliance, Volume 1: An Agenda for Research* 118, 128–129 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989).

concerned with collecting as much as possible instead of the correct amount, and indicating less satisfaction with IRS services). Members of the low-compliance group may have used these beliefs to justify noncompliance.

Surprisingly, respondents in the low-compliance group were more likely than those in the high-compliance group to believe that the IRS detects and penalizes noncompliance. This finding may seem inconsistent with the popular belief that small businesses cheat on their taxes because they do not think they will get caught (*i.e.*, insufficient economic deterrence).<sup>45</sup>

Both groups were idealistic, professing that it is morally wrong to cheat. Most members of both groups also reported that they would be embarrassed if others discovered they did not report all of their income. For those in the low-compliance group, however, other factors may have overshadowed these positive moral convictions and social pressures.

Those in the low-compliance group were more likely than those in the high-compliance group to participate in local organizations, which one might expect to be a source of positive tax compliance norms. However, they were more likely to report that other members of these organizations believe the law and the IRS are unfair, potentially countering the positive influence these affiliations might otherwise have had on tax compliance. Moreover, the closer association with local organizations by members of the low-compliance group could have undermined their connection with the nation and the national tax system as a whole.

The norms of competitors appeared to have little correlation with compliance. This may suggest that norms do not operate by reference to competitors. Rather, the views of other participants in local organizations may be more important.

Those in the low-compliance group operated slightly larger businesses and were somewhat more likely to use a preparer who could have persuaded them to comply or facilitated noncompliance—brokered compliance (or noncompliance) in the typology above. However, they were also less likely to follow the preparer's advice than those in the high-compliance group, potentially weakening any positive influence that the preparer sought to exert.

By contrast, respondents from the high-compliance group, while slightly smaller and less likely to use a preparer, were more likely to follow the preparer's advice. They were also less likely to participate in local organizations, suggesting that their compliance level was not social but motivated rather by morality, trust in government, trust in the IRS, or other internal factors contributing to high tax morale. It is unclear if affiliations and communications with those in local organizations who have little faith in government, federal tax law, and the IRS erodes the force of one's tax morale, or if those who become noncompliant seek to affiliate with those who would be more likely to feel that noncompliance was justified.

In either case, these results may suggest that the government could improve reporting compliance by improving the perceived fairness and efficiency of the government, the tax law, and the IRS; and by simplifying the tax code, improving procedural protections, and minimizing the IRS's reliance on procedures that may seem unfair (*e.g.*, excessive automation and lack of personal contact).<sup>46</sup> To address the perception by members of local groups that the tax law and the IRS are unfair, the IRS might retain a local presence and conduct outreach and education events for these groups, particularly in low-compliance communities (discussed below).<sup>47</sup>

<sup>45</sup> See, *e.g.*, Susan Morse, Stewart Karlinsky, and Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 Stan. L. & Pol'y Rev. 37 (2009) (discussing anecdotal accounts of cash businesses that did not expect the IRS to discover underreporting). This finding does not necessarily imply that taxpayers are economically irrational, particularly if they have no other source of financing and face the choice of either going out of business or underreporting. If a taxpayer could possibly use the temporary tax "savings" from underreporting to earn more than the likely tax, penalties and interest, which the IRS might collect later, then it may be rational for the taxpayer to underreport income even if he or she expects that the IRS will detect the noncompliance and impose penalties and interest. Moreover, other survey responses suggest that the low-compliance group was less risk averse than the high-compliance group.

<sup>46</sup> See, *e.g.*, National Taxpayer Advocate 2009 Annual Report to Congress 3 (Most Serious Problem: *The Time for Tax Reform is Now*) (summarizing tax simplification proposals); *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, hearing before the S. Comm. on Finance (June 28, 2011) (testimony of Nina E. Olson, National Taxpayer Advocate) (same); National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem: *The Accuracy-Related Penalty in the Automated Underreporter Units*) (recommending that IRS computers stop proposing negligence penalties); National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, at 2 (*A Framework for Reforming the Penalty Regime*) (proposing improvements to the penalty regime); National Taxpayer Advocate 2011 Annual Report to Congress 524 (recommending limits on expansion of IRS math error authority); *Options for Expanding the Remedies to Address Taxpayer Rights Violations*, *supra* (proposing remedies to strengthen procedural protections).

<sup>47</sup> See, *e.g.*, National Taxpayer Advocate 2009 Annual Report to Congress 346–50 (legislative recommendation to require at least one appeals officer and one settlement officer in each state); National Taxpayer Advocate 2008 Annual Report to Congress 176, 192 (Most Serious Problem: *Local Compliance Initiatives Have Great Potential but Face Significant Challenges*) (recommending ways to enhance local compliance initiatives). TAS has at least one office in each state and Local Taxpayer Advocates routinely conduct outreach to local groups.

### ***Key Findings of the Community Survey***

According to the 2010 Proposal, the Community Survey was to address:

What types of communities have homogeneous compliance attitudes? What local social practices, institutions (*e.g.*, volunteer, educational, and religious institutions), or attitudes increase or decrease compliance at the community level and why? Do taxpayers in communities with notably high or low levels of compliance identify more with the nation as a whole or the local community?<sup>48</sup>

One possibility was that the high-compliance communities would be homogeneous towns where residents have strong ties to local groups and institutions. This view could arise from the theory that social norms promote compliance. The Community Survey results offer a significantly different view. In short, like those in the low-compliance group, those in low-compliance communities appear to exhibit a stronger association with local institutions than national ones such as the federal government. Moreover, in constructing the Community Survey sample (described above), TAS discovered that taxpayers with high-compliance are not concentrated in homogeneous communities, at least not very many of them. Taxpayers in the low-compliance communities appeared in more concentrated geographic clusters across the country, especially in the South and West, as set forth below.

#### **Taxpayers in the high-compliance communities were more geographically dispersed than those in the low-compliance communities.**

As discussed above, to identify survey respondents who were sole proprietors, TAS used the DIF, an IRS indicator of the likelihood of underreported tax based on items reported on the return. While this measure may be imperfect, it is not geographically biased. Consequently, it was uncertain whether returns with similar compliance levels, as measured by DIF, would cluster geographically. From all areas, cities, and towns, in the U.S., those with median DIF scores in the top or bottom 30 percent constituted the low- or high-compliance communities, respectively.<sup>49</sup> As it turned out, populations ranging from 20,000 to 414,000 had measurably low compliance in 365 areas, cities and towns. At the same time, populations ranging from 22,000 to 60,000 had measurably high compliance in a few sites. The site selection process confirms a geographic aspect of tax compliance. In particular, low compliance levels clustered in geographic communities, while high compliance levels were more individually dispersed.

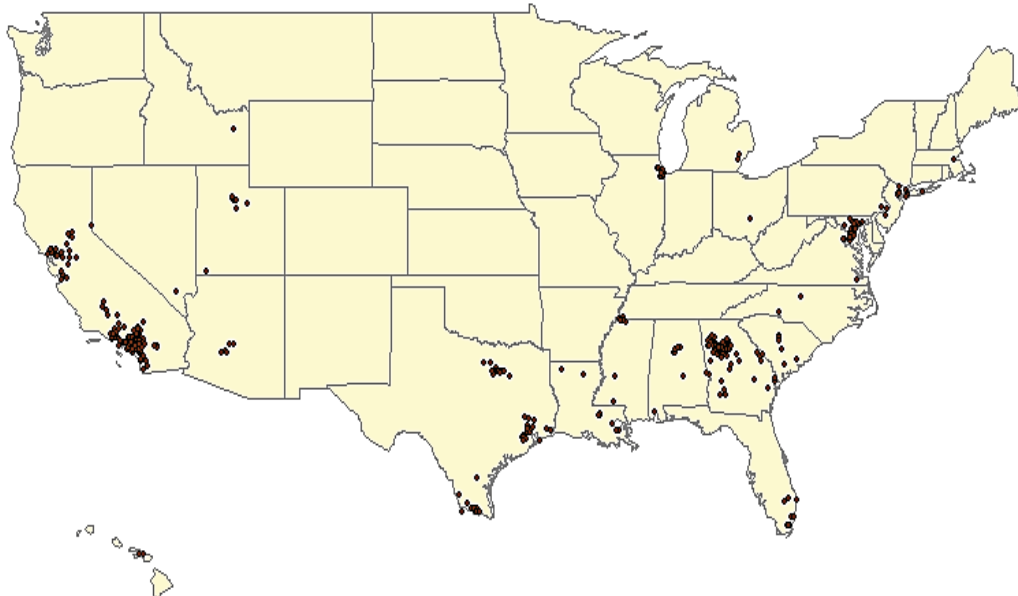
The map below shows that low-compliance communities appeared in 24 states. The map shows concentrations of low compliance, as measured, where it may become socially acceptable. The map reflects the locations of low-compliance communities but not their populations, some of which were larger than others. The site selection process was not an enforcement screen, lacking indicators of type or magnitude of noncompliance. Instead, the map helps visualize the social nature of noncompliance. The geographic observation raises issues about fostering communities of compliance given a social aspect to noncompliance.<sup>50</sup>

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<sup>48</sup> 2010 Proposal at 86–87.

<sup>49</sup> TAS identified geographic communities from the addresses with ZIP codes reported by the taxpayers on their returns, generally cities, towns, or other distinct areas as denominated by the U.S. Postal Service.

<sup>50</sup> Geographers have classified regions of the U.S. based on local history, values, behavior, and culture. See Colin Woodard, *AMERICAN NATIONS: A HIST. OF THE ELEVEN RIVAL REGIONAL CULTURES OF NO. AMER.* (N.Y.: Viking, 2011); Joel Garreau, *NINE NATIONS OF NO. AMER.* (Boston: Houghton Mifflin, 1981); Raymond Gastil, *CULTURAL REGIONS OF THE U.S.* (Seattle: Univ. of Wash. Press, 1975); Wilbur Zelinsky, *CULTURAL GEOGRAPHY OF THE U.S.* (Prentice Hall, 1973).

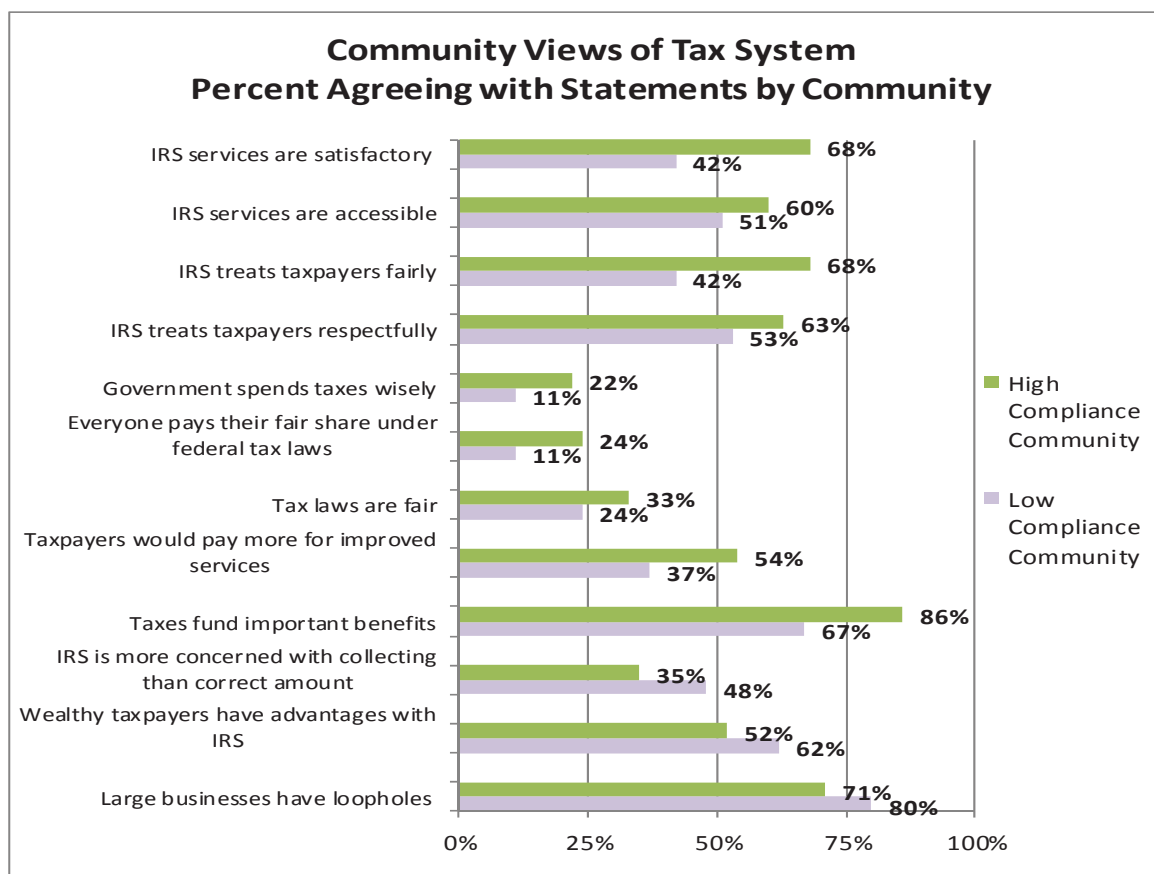
**FIGURE 13. Map of Low-Compliance Communities**

**Respondents from low-compliance communities were suspicious of the tax system and its fairness, whereas those from high-compliance communities responded positively to government.**

Respondents from low-compliance communities believed that large businesses and wealthy taxpayers have loopholes or advantages with the IRS (80 percent vs. 71 percent of those from the high-compliance communities, and 62 percent vs. 52 percent, respectively), which is more concerned with collecting as much as it can rather than the correct amount (48 percent vs. 35 percent). On the other hand, those from high-compliance communities felt that taxes fund important benefits (86 percent vs. 67 percent of those from low-compliance communities); taxpayers would pay more for improved services (54 percent vs. 37 percent); tax laws are fair (33 percent vs. 24 percent); everyone pays their fair share under federal tax laws (24 percent vs. 11 percent); and the government spends taxes wisely (22 percent vs. 11 percent). Similarly, those from high-compliance communities felt the IRS treats taxpayers respectfully (63 percent vs. 53 percent) and fairly (68 percent vs. 42 percent) with accessible (60 percent vs. 51 percent) and satisfactory services (68 percent vs. 42 percent).

While taxpayers in the low-compliance communities may tend to identify less with federal agencies, respondents from the high-compliance communities identified with the nation as a whole. In terms of the factors introduced above, respondents from high-compliance communities expressed trust in government, while the responses of the low-compliance group suggested a symbolic type of noncompliance.



**FIGURE 14. Community Views of the Federal Tax System**

Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

### **Respondents from high-compliance communities were more likely to rely on preparers.**

A substantial majority of the respondents from high-compliance communities used a third-party preparer (86 percent vs. 65 percent of low-compliance respondents) and always followed that person's advice (98 percent vs. 89 percent). Nevertheless, those from high-compliance communities made sure to understand the return before signing (91 percent vs. 84 percent from low-compliance communities).

### **Among business classifications, the biggest cluster in low-compliance communities was under "professional, scientific, or technical services"; in high-compliance communities, the "other" service industry.**

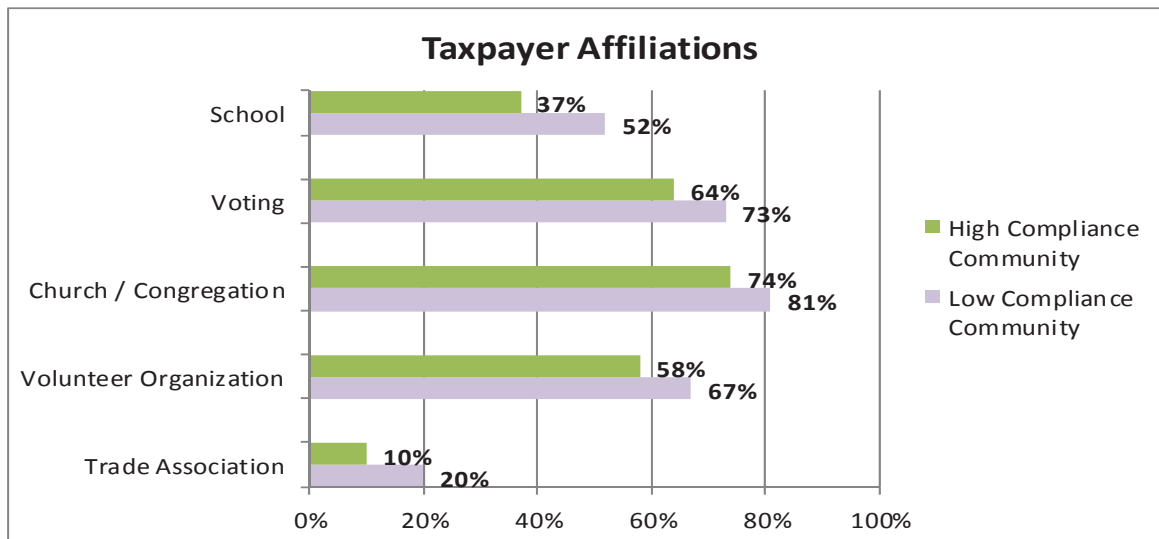
Respondents from the high-compliance communities most frequently clustered in "other services" (22 percent vs. 11 percent of low-compliance respondents), whereas those from the low-compliance communities most frequently clustered in "professional, scientific, or technical services" (22 percent vs. 11 percent from the high-compliance communities).<sup>51</sup> Those from the high-compliance communities were more than twice as likely to speak a language other than English at home (22 percent vs. 9 percent from the low-compliance communities). The Community Survey may have identified a unique type of "social" compliance related to a particular socio-economic experience, that of a linguistic minority employed in the service industry who expressed trust in government.

<sup>51</sup> Under "other" services, NAICS includes repair & maintenance, personal & laundry, civic & social, and private household services.

### Low-compliance community respondents reported more participation in civic institutions than their high-compliance community counterparts.

Low-compliance community respondents were more likely than high-compliance community respondents to belong to a trade association (20 percent vs. 10 percent), volunteer organization (67 percent vs. 58 percent), or church or other religious congregation (81 percent vs. 74 percent),<sup>52</sup> and to vote (73 percent vs. 64 percent) or send children to local schools (52 percent vs. 37 percent).<sup>53</sup> Within those affiliations, those from low-compliance communities were more likely to disagree (or strongly disagree) with the propositions that most members believe the tax laws and IRS are fair (respectively, 29 percent vs. 18 percent and 25 percent vs. 15 percent for volunteer organizations; 32 percent vs. 16 percent and 26 percent vs. 13 percent for churches; and 29 percent vs. 14 percent and 20 percent vs. 9 percent for elected officials).<sup>54</sup> In other words, those from the low-compliance communities tend to belong to groups, which they believe share the view that taxes are unfair. In terms of the factors introduced above and the typology of noncompliance, set forth in Table 1, *Typology of Noncompliance*, above, these affiliations may be a form of social noncompliance.<sup>55</sup>

**TABLE 15. Taxpayer Participation by Type of Association and Community**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

### High-compliance community respondents were motivated by morals and deterrence.

High-compliance community respondents felt that tax reporting was a moral obligation (98 percent vs. 92 percent of those from low-compliance communities) and would be embarrassed if others found out they had under-reported (90 percent vs. 76 percent). Similarly, the high-compliance community respondents were risk-averse, more frequently agreeing that hearing about people who were caught underreporting would make them more careful (86 percent vs. 70 percent). Conversely, respondents from low-compliance communities evidently were not deterred despite their belief that the IRS probably knows when people underreport income (62 percent vs. 52 percent from the high-compliance communities). An inference could be made that deterrence efforts affect those predisposed to compliance.

<sup>52</sup> This difference is not statistically significant at a 95-percent level of confidence.

<sup>53</sup> This trend was generally consistent with that in the National Survey, except the frequency of voting among the low-compliance group was not higher than that of the high-compliance group.

<sup>54</sup> Additional comparisons, not statistically significant at a 95-percent level of confidence, were 55 percent vs. 47 percent and 46 percent vs. 36 percent for trade associations, and 42 percent vs. 15 percent and 37 percent vs. 9 percent for parents.

<sup>55</sup> If taxpayers from a low-compliance community feel that they have a support group in certain institutions—social noncompliance—then civic education addressing those institutions could leverage enforcement efforts. Civic education would mean not technical training on particular tax provisions, but “the cultivation of the virtues, knowledge, and skills necessary for political participation.” Amy Gutmann, *DEMOCRATIC EDUCATION* (Princeton Univ. Press, 1987) 287. Maintaining a low level of tax compliance may be a form of political non-participation motivated by a skepticism of fairness in taxation—symbolic noncompliance—as described in the typology of noncompliance. Thus, popular dissemination of information about the institutions that ensure fairness, e.g., the checks and balances created by an independent judiciary and Congressional oversight, could be a responsive form of civic education.

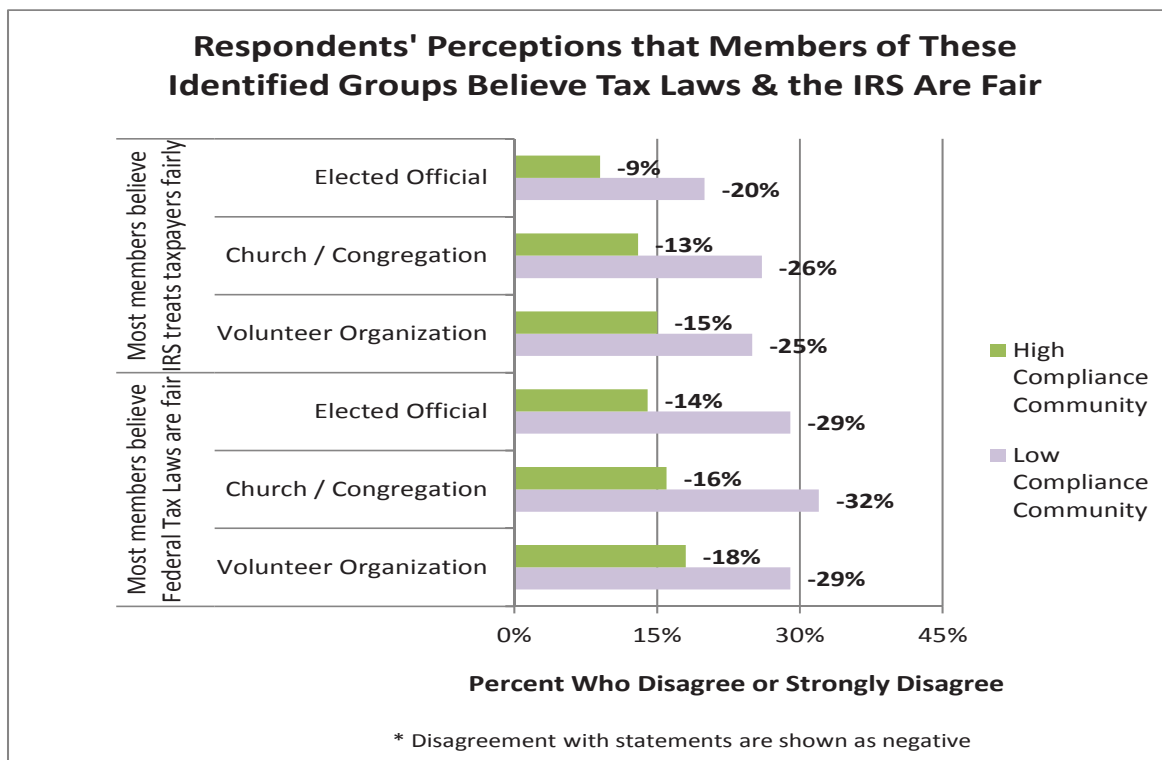
The effect on compliance of financial concerns by those in high- or low-compliance communities was unclear.

Paradoxically, respondents from high-compliance communities were more likely to feel that most small businesses could not survive if they reported all of their income (23 percent vs. 16 percent of low-compliance community respondents). However, the National Survey did not reproduce this result (12 percent vs. 15 percent of the low-compliance group).<sup>56</sup> In terms of the factors discussed above, it is unclear that deterrence motivated compliance. In terms of the typology introduced above, “asocial” noncompliance due to financial incentives did not appear as a major force in the Community Survey.

Those in the high- and low-compliance communities responded similarly to questions addressing complexity.

Both groups responded without significant difference to questions about how complicated the tax rules are (64 percent of the highly-compliant vs. 63 percent of low-compliance respondents) and the clarity of income reporting rules (73 percent vs. 68 percent). Consequently, the Community Survey did not reveal significant procedural, “lazy,” or unknowing noncompliance.

**FIGURE 16. Respondents’ Perceptions that Members of These Identified Groups Believe Tax Laws & the IRS Are Fair**



Except as otherwise noted, all of the differences between the two groups are statistically significant at the 95-percent level of confidence.

<sup>56</sup> This difference is not statistically significant at a 95-percent level of confidence.

### Summary of the Community Survey Results

The Community Survey focused on areas that did not represent the nation as a whole but did represent locales where tax compliance levels were markedly low or high. The site selection process identified hundreds of low-compliance communities, indicating a social aspect of noncompliance consistent with questionnaire responses showing a high degree of social affiliations. On the other hand, there were so few high-compliance communities as to make them prototypical rather than typical. The high-compliance communities may have had unique experiences with government contributing to an ideal type of “social compliance” that could be the obverse of social noncompliance typology. Additionally, the high-compliance communities responded positively to morals and preparers as well as deterrence. By contrast, the low-compliance communities evidently were not deterred even though they believed that the IRS could detect under-reporting. The combination of risk tolerance and geographic concentration of low-compliance communities could form the basis for targeted innovation in tax administration that would go beyond deterrence toward the social and moral factors underlying compliance.

### Preliminary Observations

As reflected in the 2007 Review, social norms and related factors may help explain tax compliance. As discussed above, TAS designed a survey questionnaire to probe into norms and related factors. While this survey elicited direct responses from taxpayers, the “social” nature of norms should be observable even beyond these responses, potentially by observing characteristics of the high- and low-compliance communities or regions. Future research could build upon the survey results by investigating social noncompliance and social compliance in sites where they occur.<sup>57</sup> While tax reporting may be a private decision, compliance levels appear to depend on values that are shared or at least commonly understood.<sup>58</sup>

Commonly understood values are social or geographic, and therefore susceptible to study through market research or public sources beyond the questionnaire. What is the “means of communicating these learned beliefs, memories, perceptions, traditions, and attitudes that serves to shape behavior”?<sup>59</sup> Not all behavior stems from local interaction.<sup>60</sup> Yet geographically-dispersed populations, such as diasporas with common origins in the past, or virtual communities on the Internet, may be exceptions that prove the rule.<sup>61</sup> Like tax administration as a whole, compliance research could advance by meeting taxpayers where they are, in geographic locations where they build communities around common behavior.

In this study, tax compliance has turned out to be “retail.” Clusters of measurably similar compliance levels may lie in a cultural region. While individual predispositions like risk aversion are factors, they are expressed within regional norms.<sup>62</sup> Seemingly nongeographic behavior may exhibit regional effects that researchers have isolated using statistical techniques such as “regression analysis”—analysis used to understand how a “dependent variable” (e.g., legal compliance) changes when any one of the “independent variables” (e.g., location or other relevant factor) changes.<sup>63</sup>

<sup>57</sup> Whereas the survey method may be consistent with “[m]ost theories in social science today” which “are based on the assumption that individuals are atomistic and thus independent of one another,” this assumption “leaves unresolved the problem of accounting for the order one finds in society.” James Duncan, *The Superorganic in American Cultural Geography*, 70 ANNALS OF ASSOC’N OF AMER. GEOGRAPHERS 181, 183 (1980).

<sup>58</sup> “Culture is public, because meaning is.” Clifford Geertz, *Thick Description: Toward an Interpretive Theory of Culture*, INTERPRETATION OF CULTURES (N.Y.: Basic Books, 1973) 12.

<sup>59</sup> Mona Domosh, Terry Jordan-Bychkov, et al. THE HUMAN MOSAIC: A THEMATIC INTRO. TO CULTURAL GEOGRAPHY 12th ed. (N.Y.: W.H. Freeman & Co., 2012).

<sup>60</sup> “As a cerebral entity, a culture may flourish, move about, and propagate itself solely within the heads of a number of footloose individuals. Such extreme cases do occur, of course, but normally the facts of location and the processes of interaction with other localized or spatially structured phenomena do matter greatly.” Wilbur Zelinsky, CULTURAL GEOGRAPHY OF THE U.S. (Prentice Hall, 1973) 76.

<sup>61</sup> Even Internet use depends on users’ geographic location. See, e.g., Eric Gilbert, Karrie Karahalios & Christian Sandvig, *Network in the Garden: An Empirical Analysis of Social Media in Rural Life*, Conf. on Computer-Human Interaction of Assoc’n for Computing Machinery, Florence (2008).

<sup>62</sup> Why would tax compliance, among other characteristics, be part of cultural geography? “Imagine someone who is, among other things, a Czech-American Lutheran plumber, a member of the VFW, an ardent Cleveland Indian fan, a radio ham, a regular patron of a particular bar, and a member of a car pool, the local draft board, the Book-of-the-Month Club, and the Republican party, and a parent whose son attends a particular college. Each of these subcultures will tend to have its own array of gear and physical arrangements, spectrum of economic and social beliefs and practices, cluster of abstract concepts, and, not least important for our purpose, distributional spread in physical space.” Zelinsky, CULTURAL GEOGRAPHY at 74.

<sup>63</sup> “While differences in standard demographic or economic variables such as age composition, median education, or median income account for a good deal of the variance among sections of the country” in particular social statistics, “there is a significant remainder that may be related” solely to geographic characteristics. Raymond Gastil, CULTURAL REGIONS OF THE U.S. (Seattle: Univ. of Wash. Press, 1975) 116.

By identifying high- and low-compliance communities, this survey prepares the way for potential research in particular geographic areas. Relevant aspects of high compliance, such as trust in government or respect for authority, may occur throughout the country, even if not in a high-compliance community. Future research could go beyond the factors underlying compliance to test how tax administration may respond to regional traditions with certain services in particular geographic regions.<sup>64</sup>

Future research could also use more sophisticated tools to analyze the National Survey data. While this preliminary analysis identified important correlations between (estimated) tax compliance and responses to the survey questions, applying “regression analysis” (described above) to the data might provide further insight into which responses (or other observable factors) have the greatest effect on (estimated) tax compliance. For example, while this preliminary analysis reveals a correlation between estimated tax compliance and attitudes about the government, the law, and the IRS, a regression analysis might reveal the relative importance of these attitudes after controlling for the effect of other factors.

Alternatively, data mining techniques (e.g., “segmentation” or “cluster” analysis) could identify groups of survey responses that are most frequently associated with each other. Such analysis might enable researchers to identify various distinct types of noncompliance. For example, this analysis might find a particular segment of the low-compliance group for whom complexity presents a barrier to compliance. It might distinguish this segment from another for whom complexity is not a barrier, but justifies noncompliance on the basis of negative views about the IRS, the law, and the government. Such analysis might help to inform policymakers about how to tailor an effective approach to address different types of noncompliance and different segments of the population.

## Conclusion

In conclusion, the TAS survey has helped to identify which factors significantly influence compliance. In turn, analyses of the factors and related data point to the operative types of noncompliance. Finally, knowledge of these factors and types of noncompliance can inform service and enforcement programs.

The results of both surveys suggest that norms and distrust of the national government, the law, and the IRS may promote noncompliance. Respondents from both the low-compliance groups and from low-compliance communities held negative views about government and the IRS and were more likely to participate in local organizations. They were also more likely to believe that other members of those organizations held similarly negative views, which appeared to reinforce their own views, though they generally professed that noncompliance was morally wrong. In other words, they affiliated with others who reinforced noncompliance norms at the local level, and probably feel a closer connection to a local collective than to the national collective. In terms of the typology discussed above, this tendency to affiliate where distrust of government is the norm may be a form of social and symbolic noncompliance.

Consistently, the results also suggest that tax morale and trust in government, the law, the IRS, and preparers may promote compliance. Respondents from the high-compliance group and the high-compliance communities were less likely to participate in local organizations, suggesting that their compliance level was not social but motivated rather by morality, trust in government, trust in the IRS, or other internal factors contributing to high tax morale.

Those in both the high- and low-compliance groups also expressed a high level of trust in a preparer, but those in the high-compliance group expressed more trust. Similarly, a greater reliance on preparers by respondents from the high-compliance communities suggested a type of “brokered compliance.” Thus, the survey

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<sup>64</sup> See Most Serious Problem: *The IRS Is Substantially Reducing Both the Amount and Scope of Its Direct Education and Outreach to Taxpayers and Does Not Measure the Effectiveness of Its Remaining Outreach Activities, Thereby Risking Increased Noncompliance*, supra; National Taxpayer Advocate 2009 Annual Report to Congress 346 (Legislative Recommendation: *Strengthen the Independence of the IRS Office of Appeals and Require at Least One Appeals Officer and Settlement Officer in Each State*); National Taxpayer Advocate 2007 Annual Report to Congress 162 (Most Serious Problem: *Service at Taxpayer Assistance Centers*); National Taxpayer Advocate 2003 Annual Report to Congress 145 (Most Serious Problem: *Taxpayer Assistance Centers*).

results suggest that “brokered compliance” may be a potential benefit of a well-regulated preparer profession, which the National Taxpayer Advocate has long championed.<sup>65</sup>

The survey results did not reveal as much about the effect of deterrence and complexity on reporting compliance. With respect to deterrence, this may have been because some respondents answered defensively—to avoid explicitly implicating themselves in noncompliance. With respect to complexity, the survey did not specifically identify procedural, “lazy,” or unknowing noncompliance as posing major concerns. Nonetheless, complexity likely promotes the view that the government, the law, and the IRS are unfair or cannot be trusted, and the survey responses suggest that these views may reduce compliance.

Given the emergence of social and symbolic noncompliance as the primary types of noncompliance among small businesses, treatments that promote trust in government, the law, and the IRS may be most effective. As a practical matter, this might include tax simplification, an expansion of taxpayer protections and remedies, and taxpayer education.<sup>66</sup> This kind of education would be normative, relating to trust in government, rather than technical.<sup>67</sup> Traditional enforcement measures designed to deter could be ineffective, both because those likely to respond may be predisposed to comply and because the survey results did not suggest that asocial behavior (*i.e.*, behavior that may be addressed by increasing deterrence) is prevalent.<sup>68</sup>

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<sup>65</sup> See 2010 Proposal at 81 (Table 2.4.1, *Typology of Noncompliance and Potentially Operative Factor(s) Identified by the Literature*); National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*); National Taxpayer Advocate 2004 Annual Report to Congress 67 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers Oversight and Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

<sup>66</sup> For a discussion of procedural protections that could improve trust in government, see National Taxpayer Advocate 2011 Annual Report to Congress 493–518 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*) and National Taxpayer Advocate 2007 Annual Report to Congress 478–489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis “Apology” Payments*). For a summary of the National Taxpayer Advocate’s simplification proposals, see Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What’s Due, *Hearing Before the S. Comm. on Finance* (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>67</sup> For a discussion of the types of education that might be effective, see 2007 Review at 162–170.

<sup>68</sup> On deterrence, TAS has initiated further research on the effect—if any—of audits on subsequent reporting compliance as measured by the DIF.